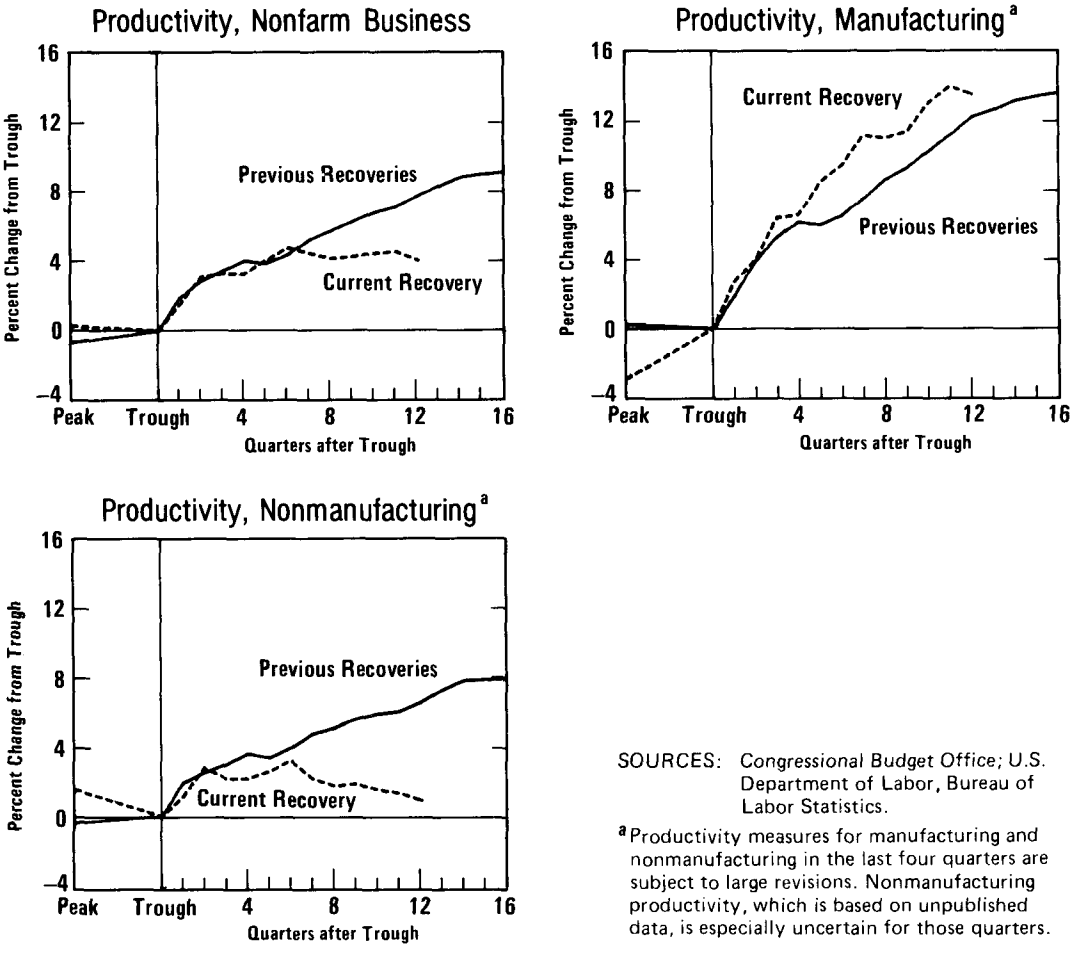
Index (a measure of prices paid by consumers that includes prices of imported goods). Excluding changes in prices of food and energy, inflation in final-goods prices has risen moderately in the past two years (see Table I-12).

The rate of inflation was lower on average in the last half of 1985 than had been expected--the result of falling prices of food, energy, and used cars. Some prices began to increase more rapidly in recent months, but mostly for special reasons that are not expected to persist. Thus, meat prices were low for most of the year because of temporary increases in slaughter rates that are now coming to an end. On average, however, the price of food purchased by consumers to eat at home increased by only 2.1 percent over the 12 months of 1985. Oil prices also increased temporarily in

Figure I-10.
Cyclical Comparisons of Productivity Growth



SOURCES: *Congressional Budget Office*; U.S. Department of Labor, Bureau of Labor Statistics.

[a] Productivity measures for manufacturing and nonmanufacturing in the last four quarters are subject to large revisions. Nonmanufacturing productivity, which is based on unpublished data, is especially uncertain for those quarters.

the fall, the result of low oil inventories at the beginning of the heating season in the United States and Europe. As a result, the CPI increased somewhat faster during the last three months of the year than it had from May through September. (The sharp oil price declines late in December occurred too late to affect 1985 inflation significantly.)

The outlook for inflation in the next year is highly uncertain. Some developments could lead to much lower inflation:

- Oil prices have fallen dramatically in recent weeks and in early February were about 46 percent below what they were in November. In coming months, these declines could significantly reduce the growth of the CPI, and, to a lesser extent, that of the GNP deflator.

TABLE I-12. INFLATION (Percent change, fourth quarter to fourth quarter)

Price Measure	1980	1981	1982	1983	1984	1985
Fixed-Weight GNP Deflator	9.8	8.5	5.0	3.8	4.2	3.5
CPI for All Urban Consumers a/	10.9	8.8	5.3	3.6	4.1	3.5
Stripped CPI b/	9.4	8.6	6.2	4.1	4.5	4.7
PPI Finished Goods	12.3	7.2	3.5	0.8	1.7	1.6
PPI Crude Materials	14.2	-2.6	-0.8	4.3	-1.1	-5.9
PPI Crude Oil	33.5	30.2	-7.3	-7.5	-2.5	-5.7
PPI Refined Petroleum Products	28.2	13.6	-6.0	-9.3	-4.6	-2.0
CPI for Food at Home	10.7	3.7	2.5	1.4	3.8	1.4
CPI for Energy	18.9	12.6	1.9	-1.7	0.3	0.9

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

a. The Consumer Price Index (CPI) is published in two versions: the CPI-U for all urban consumers, shown here, and the CPI-W for urban wage and clerical workers, shown in the projections in Table I-3. Before 1983, both measures used a flawed measure of the cost of homeownership; this was corrected in 1983 for the CPI-U, reported here, and in 1985 for the CPI-W. The CPI growth rates for 1980-1982 reported here are those of an experimental CPI measure that approximates the current CPI treatment of homeownership.

b. CPI less food at home, energy, and used cars.

- Other commodity prices, especially for agricultural commodities, remain weak, and prices for some crops are expected to fall this year.

- Wage gains have been moderate, as explained earlier.

Other important developments, however, point to a possible increase in the inflation rate:

- The money supply (M1) has increased at an average annual rate of about 9 percent over the past two years, as the discussion above points out. The possible delayed effects of this growth could lead to inflationary pressures in labor markets and other sectors next year. While unemployment is currently not at inflation-generating levels, it has been moving down, and should a strong delayed effect from last year's monetary growth materialize, it could put it in the danger zone.

- The exchange rate of the dollar has depreciated 16 percent over the past year and is expected to continue falling.

In combination, these factors make the inflation forecast unusually uncertain.

Special Factors Holding Down Inflation. The massive appreciation of the dollar from early 1980 to early 1985 played a large role in reducing inflation rates. Most estimates suggest that as the dollar appreciated by 60 percent to 85 percent, it reduced annual inflation rates (measured by consumer prices) by between one and two percentage points.

The dollar reached its peak in early 1985, then fell about 21 percent and finished the year about 16 percent below its value in December 1984. This development should eventually put upward pressure on prices in the United States. The timing and magnitude of this effect are difficult to predict, however. This is because the recent declines in the dollar's international value may have been partly absorbed in changes in the profit margins of foreign exporters, as well as of importers and distributors in the United States, rather than being passed through to ultimate purchasers. Some markets where imports have a dominant market share, such as consumer electronics and semiconductors, have already experienced price rises. The falling dollar is likely to begin soon to put upward pressure on prices of domestically produced goods and services as well.

Falling oil prices have also contributed to the decline in inflation (see Figure I-11). The downward drift of oil prices since 1980 has come about in part because of the conservation measures precipitated by the oil price

BOX I-2

THE OIL PRICE COLLAPSE

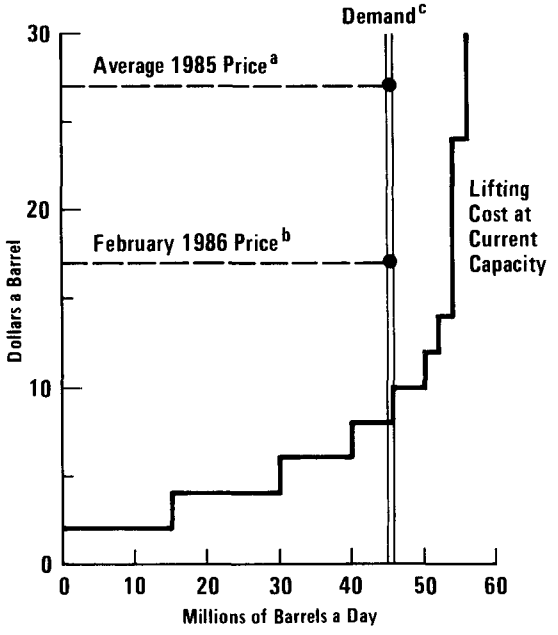
Since November 1985, crude oil prices have plummeted from over $28 a barrel to below $17 a barrel as of the first week of February 1986. Prices remain extremely volatile, and neither a resurgence nor a further decline can be ruled out. At $17 a barrel, oil prices in real terms are about 25 percent below their average level in 1974, immediately following the first large price increase by OPEC, but about three times their level in early 1973. At its peak in 1981, the real price of oil was nearly seven times its early 1973 level.

The immediate cause of the collapse in oil prices was a decision by Saudi Arabia to increase its share of the world oil market by raising production levels. This represents a reversal of its longstanding policy of stabilizing prices by restricting output, a policy that had forced it to reduce output by almost 80 percent between 1981 and 1985. In summer 1985, Saudi oil output fell to a low of 2.2 million barrels a day (mmbd), about half of its OPEC quota. The Saudis had borne the brunt of OPEC's effort to defend prices in the face of growing world oil production and stagnant world demand. The recent increase in Saudi Arabian output by at least 2 mmbd, combined with higher output from several other members of OPEC, has raised total OPEC crude oil output from a low of around 14 mmbd to at least 18 mmbd over the last six months. With non-OPEC supply remaining constant, the current supply of crude oil to free-world consumers is about 47-49 mmbd, which is about 2-3 mmbd in excess of current use. This excess supply has caused prices to fall. Since demand responds only weakly to oil price changes over the short run, a severe drop in price is required to induce enough of an increase in quantity demanded to clear the market. Given current production plans, this could mean market clearing prices in the $12 to $16 range. (This calculation uses standard estimates of short-run demand responsiveness to price changes. A decline in price to about $14 a barrel would force only about 1 mmbd of production to be shut down worldwide in the short run.) It is impossible, though, to predict how producers with excess capacity might respond to such lower prices. Considering that almost all the world's excess capacity is concentrated in the lowest-cost OPEC producers, almost half of it in Saudi Arabia, if OPEC decided to produce at full capacity, prices could fall to as low as $8 to $10 a barrel in the short run. In the long run, shifts in supply and demand for oil would probably cause these prices to rise substantially.

Whether prices actually go that low will depend on whether producers try to organize again, as OPEC first did in the early 1970s.

Indeed, the approach of producers--both OPEC and non-OPEC--to coordinating output levels is the major uncertainty for the oil market in the near term. A key concern influencing any prospective agreement among producers is how revenue from oil sales is affected by various combinations of output and price. Using a plausible scenario, oil prices might stabilize at $15 a barrel when OPEC members produce 19 mmbd, or at $25 a barrel if they produce 14 mmbd. At 19 mmbd, their annual revenues would be about $104 billion compared to around $128 billion at 14 mmbd. In this example, OPEC collectively gains from higher prices; in the short run, however, individual OPEC members might have different interests. For Saudi Arabia, production of 5 mmbd at $15 a barrel yields about $27 billion annual sales, while 2.5 mmbd priced at $25 a barrel brings in only $23 billion. In this case, at least in the short term, Saudi Arabia loses with higher prices. Given Saudi unwillingness to incur further revenue losses in order to support higher prices, oil prices are likely to remain well below their 1985 levels unless other producers agree to limit output in a manner deemed equitable by Saudi Arabia. To put any such decision in perspective, eliminating the current excess output of 2-3 mmbd would involve an across-the-board reduction of only about 7 percent to 10 percent from current production levels on the part of OPEC and major non-OPEC oil exporters.

Lifting Cost of Crude Oil



SOURCES: Congressional Budget Office; Texas Eastern Corporation; Exxon Corporation.

[a] OPEC output in 1985 averaged 16 million barrels a day.

[b] OPEC output in early 1986 was about 18.5 million barrels a day.

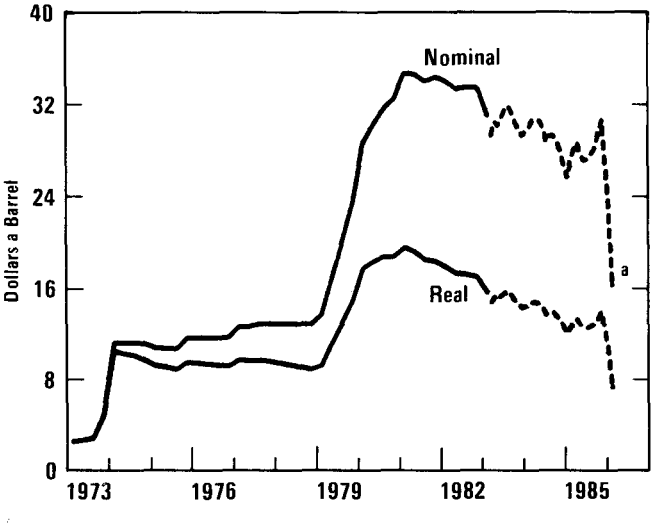
[c] Free world consumption in 1985 and the rate of consumption estimated for early 1986 are approximately 45-46 million barrels a day (consumption does not change much in response to price changes in the very short run).

increases of 1974 and 1979, and partly from strong growth in world supply. Since the trough of the past recession in the fourth quarter of 1982, oil consumption in the United States has increased only 4 percent, while real GNP has increased 14.1 percent. Because oil is priced in dollars, until the recent dollar depreciation it grew more expensive relative to other goods in many countries whose currencies are not tied to the dollar, encouraging even more conservation abroad.

The downward pressure on oil prices has recently been increased by a change in OPEC's policies (see Box I-2). OPEC has had to face growing production from countries outside its membership. It stemmed price declines for a while by cutting its own production, with a large proportion of the cuts made by Saudi Arabia. Recently, Saudi Arabia has indicated that it would seek to increase its market share even at the cost of a sharp price reduction. Prices fell dramatically in the New York market in response to this announcement; at one point in February, the price of oil for delivery in March was below $16.00, down from about $28.50 in November.

Another factor in the decline of inflation has been the weakness in prices of agricultural products and of some other major internationally traded commodities. The downward pressure on these prices has stemmed partly from the dollar's appreciation, but has been magnified by increases in production that are not directly related to demand increases. Some

Figure I-11.
Nominal and Real Oil Prices



SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis; Central Intelligence Agency, Directorate of Intelligence; New York Mercantile Exchange.

NOTE: The nominal price series is the official OPEC price (quarterly data) until 1983:1. The N.Y. Mercantile Exchange forward price for oil to be delivered in the next month is used thereafter. The real price series is the nominal price divided by the fixed-weight GNP price index.

[a] Average forward price in the first week of February for oil to be delivered in March.

examples are big harvests in the United States and elsewhere, the increasing self-sufficiency of developing countries in food, and increases in raw-material production that are part of the long-term development plans of some poorer countries.

The farm support system in this country has partly offset the farm income losses that normally would accompany commodity price declines, but at the cost of lower exports and a large increase in the federal deficit (see Box I-3). (The European Community has a similar farm support policy, but sells its excess production on the world market rather than holding it in stockpiles. This contributes to the U.S. farm problem.) The Food Security Act of 1985 reduces support prices for farm products in order to stimulate exports. World prices of farm products are thus likely to drop further, which should help to keep inflation down in 1986.

Closely related to the weakness of the dollar and of commodity prices is the relative sluggishness of domestic demand in other advanced countries, as compared with that in the United States. Japan's domestic demand growth since the U.S. recession trough has been only about half as strong as that of the United States, while demand in major European countries has grown even less strongly. In part, this discrepancy is the result of restrictive monetary and fiscal policies in many countries. These policies were undertaken to confront the same problem of high inflation that the United States faced, and to counteract depreciation of some currencies. The effect of these policies has been to keep the growth of demand in the rest of the industrial world well below that of the United States. This, in turn, has moderated inflation throughout the developed world and held down prices of traded goods.

Underlying Determinants of Inflation. Among the fundamental domestic determinants of inflation are the rates of unemployment and capacity utilization, and monetary policy. Because the last recession was very deep, the economy has not yet returned to levels of employment and capacity utilization typical at this stage of a business cycle. The unemployment rate remains above the level that presages an increase in the rate of inflation. Moreover, the estimated "noninflationary" unemployment rate is likely to move down over the next few years as the members of the large recent bulge of new entrants to the labor force advance in their careers. Capacity utilization in manufacturing, at 80.3 percent in December 1985, was about three percentage points below the rate at which inflation has accelerated in the past.

A period of sustained rapid growth in the money supply, such as experienced recently, would traditionally have been seen as a harbinger of

BOX I-3

THE PLIGHT OF THE AGRICULTURAL SECTOR

Farming in the United States is now closely linked to economic conditions abroad. During the 1970s, world demand for farm commodities outstripped foreign production, pushing up prices, profits, and land values in the United States. But in the 1980s the picture changed. Counterinflationary economic policies in many countries resulted in lower economic growth, dampening world demand for agricultural products. At the same time, farm production abroad was stimulated by favorable price movements, government subsidies, and improved technologies. Rising supply and flagging demand have exerted downward pressure on prices, causing U.S. farm exports to fall sharply over the last year.

Farm production in the United States remains modestly profitable, even though the total return on average farm equity, inclusive of imputed capital losses caused by falling land values, has turned negative. Increases in production and government income and price supports have significantly offset the effect of lower prices on farm incomes. Nevertheless, some heavily-indebted farmers are faced with severe financial hardship because they must pay back debt incurred when prices were high with income generated when prices are much lower. Many farmers have progressively reduced their debt service burden, aided by lower interest rates, and are limiting future debt accumulation by cutting back on new machinery and land purchases.

World demand for U.S. agricultural output is likely to increase in the future if the dollar continues to depreciate and U.S. farm support prices fall. Still, foreign supply capacity and prospects of only moderate foreign income growth will force the U.S. farm sector to continue retrenching until it returns to operating conditions more closely resembling the 1960s than the 1970s.

The Farm Security Act of 1985 is designed to facilitate this adjustment. It provides incentives to reduce farm production by tying acreage reduction requirements to eligibility for price and income support programs and by introducing a program to discourage farming of highly erodible land. Also included are provisions that reduce price support levels (loan rates) in an effort to stimulate demand, while maintaining income support levels (target prices for deficiency payments) in order to moderate declines in farm income.

increased inflation. For much of the 1980s, however, the relationship between money and the economy has been so volatile as to make it difficult to make such forecasts with confidence, as the discussion earlier in this chapter showed. The ratio of GNP to the money supply--referred to by economists as monetary velocity--has fallen drastically for reasons that are not well understood. Because of this decline, the Federal Reserve has been able to increase the growth of M1 without an increase in inflation. CBO assumes in its forecast that if velocity starts to increase rapidly, the Federal Reserve will offset the increase with slower money growth.

The Outlook for Inflation. Most current forecasts show inflation rising marginally from 3.5 percent in 1985 (as measured by the CPI) to the 3.5 to 5.0 percent range in the 1986-1987 period. This outlook embraces a number of offsetting factors, and is therefore subject to great uncertainty. On the one hand, a declining dollar could give inflation an upward push over the next year. This might be reinforced by continued rapid money growth, if it was not offset by velocity changes. On the other hand, a continuing decline in the international price of oil and weakness in other commodity prices (especially food) would work to reduce inflation, as would a continuation of the recent steadiness in real wages.

Consumption

In 1985, personal consumption expenditures grew 3.2 percent after inflation, faster than both GNP and disposable income. This growth is reflected in a drop in the personal saving rate, various measures of which are shown in Figure I-12. 9/ A relatively low saving rate is not unusual during periods of recession or sluggish growth; at such times, people try to maintain relatively smooth consumption patterns in the face of interruptions of income growth. 10/ This does little, however, to explain the current low saving rate, which has persisted well into the economic expansion.

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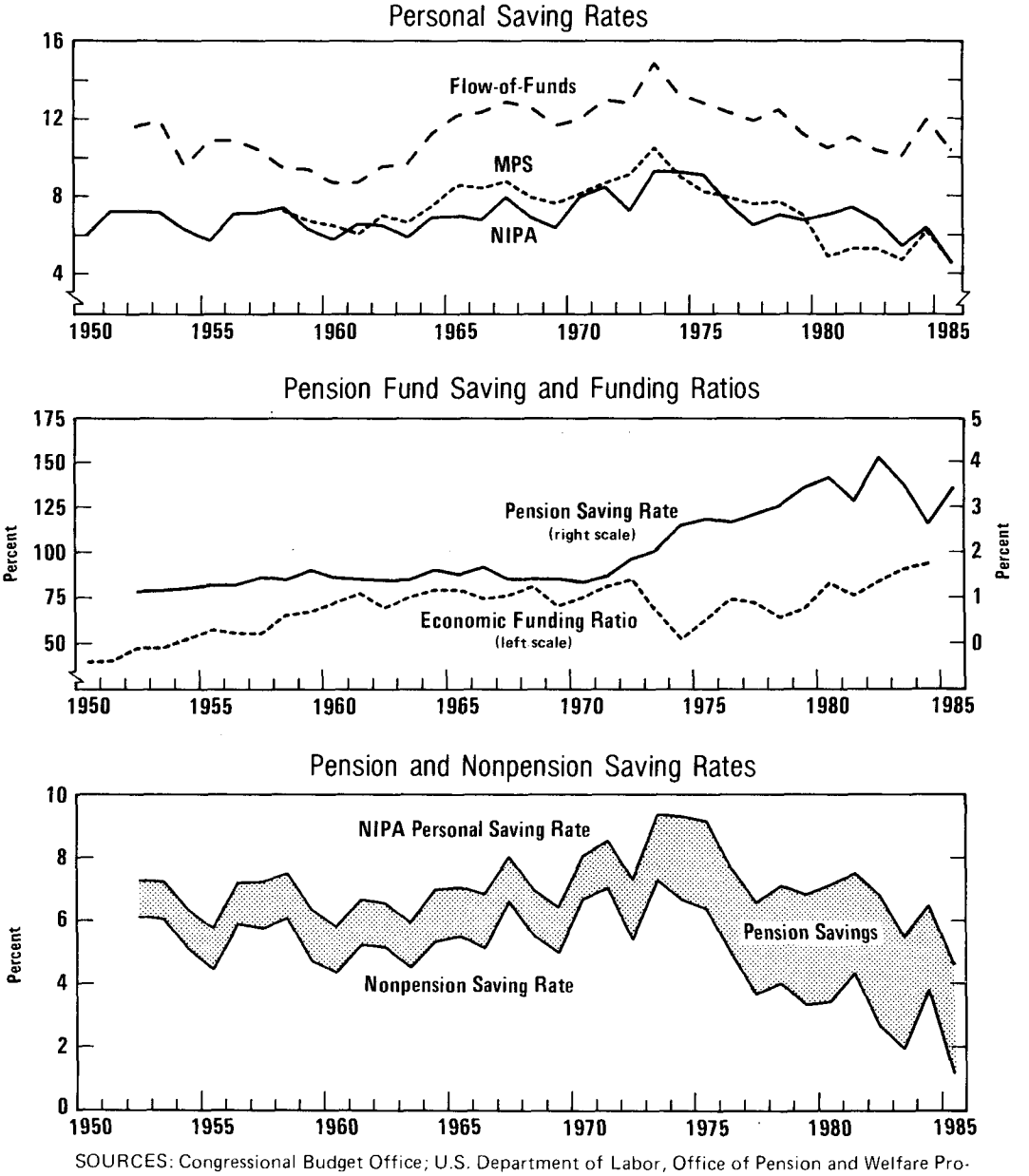
9. The saving rate was revised upward with the recent NIPA revisions. The revised data still show a significant decline since the late 1970s, however.

10. Another factor that can explain shifts in saving is a changing age composition of the population. People often save little when they are very young or very old. As a result, the overall saving rate can drop if the proportion of the population that is accounted for by these groups rises. Most analysts doubt, however, that this is a significant factor behind the relatively abrupt decline in the saving rate experienced in the last year.

Figure I-12.

Personal Saving Behavior



SOURCES: Congressional Budget Office; U.S. Department of Labor, Office of Pension and Welfare Programs; Federal Reserve Board; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTES: Flow-of-Funds: approximately, saving plus net purchases of durable goods (purchases less depreciation of the existing stock) and additions to government life insurance and retirement accounts.
MPS: includes in saving purchases of durable goods, but subtracts their imputed service flows.
NIPA: the basic National Income and Product Accounts personal saving rate.
Pension Saving Rate: net acquisitions of private pension funds as a percent of personal disposable income.
Economic Funding Ratio: ratio of pension fund assets to the present value of obligations.

Purchases of durable goods rose much faster than overall consumption in 1985, but unevenly because of swings in auto sales. Spurred by factory discounts and financing incentives, auto purchases rose very sharply in the third quarter and declined in the fourth quarter as sales incentives ended. Real new auto purchases were up 6.9 percent in 1985 over 1984; consumer durables as a whole were up 8.2 percent. A new round of financing incentives spurred auto sales again in early 1986, but the increase is likely to be short-lived, as it was last year.

Purchases of durables are often erratic. Such movements act to shift the measured saving rate. Durable goods are not consumed immediately, of course, and may last many years. Even allowing for this, however, the personal saving rate still appears low.

Net Worth. Relatively strong household net worth may account for much of the recent pattern of strong consumption and weak saving. The ratio of net worth to disposable income has been higher all through the 1980s than at any time in the 1970s, although its rate of increase has been slowing. The measured saving rate tends to be low when household net worth is relatively high, and vice versa. When net worth is high, people feel that their futures are well provided for, and that they have less need to save.

This type of behavior is also evident in the management of private pension funds, where developments directly affect the NIPA measure of personal saving. As Figure I-12 shows, when the funding ratio--a measure of the assets of a pension fund relative to its current and future obligations--is high, net acquisitions of the fund, principally employer contributions, tend to slow. Because these contributions are included in personal savings, a slowing reduces the measured rate of personal saving. The figure breaks the personal saving rate into pension fund saving--net acquisition of pension fund assets--and nonpension saving. The relative pace of pension fund saving has slowed noticeably in the 1980s consonant with the increase in the funding ratio, and this has contributed to the decline in the overall NIPA saving rate. The decline in nonpension saving has been even more significant.

Consumer Debt. The ratio of consumer installment debt to disposable personal income is at an all-time high of 18.9 percent, but this in itself may not be cause for serious concern. Overall, household net asset and liquidity positions have improved significantly during the 1980s. In addition, falling interest rates are expected to ease the burden of installment purchases. On the other hand, the delinquency rate on consumer debt has recently edged upward to 2.4 percent in the third quarter of 1985 from 2.1 percent a year earlier.

The Outlook for Consumption. CBO anticipates that consumption will continue to grow moderately, though somewhat more slowly than the economy as a whole, during the next year. But the outlook is very uncertain. If interest rates are not as low as market participants currently expect, or if the stock market falls for some other reason, the value of existing assets will fall. This could lead to a retrenchment in consumption as households acted to rebuild their net asset positions.

Uncertainty surrounding the exact method of satisfying the budget deficit targets in fiscal year 1987 adds to the difficulty in forecasting consumption. There is no basis yet for predicting the particular changes in federal spending and, possibly, taxes that may occur, so the effects of the legislation on consumption cannot be gauged.

Business Fixed Investment

Business fixed investment had another good year in 1985, although its growth slowed substantially from the pace of the previous year (see Table I-13). Spending on equipment followed a seesaw pattern with much of the instability concentrated in two major categories: autos and trucks, and office equipment (which includes computers). The introduction of a new generation of mainframe computers was one of the factors contributing to the uneven pattern in spending for equipment. Real investment in structures slowed sharply after the first quarter and continued growing relatively slowly after that.

TABLE I-13. RECENT TRENDS IN BUSINESS FIXED INVESTMENT
(Percent change at annual rates)

	1983	1984	1985	1985 I	1985 II	1985 III	1985 IV
Nonresidential Structures	-9.5	14.6	11.4	19.8	5.2	1.2	6.4
Producers Durable Equipment	3.2	22.2	8.7	-10.2	16.9	3.0	12.4
Total	-1.8	19.5	9.6	-0.5	12.5	2.4	10.3
Real GNP	3.4	6.6	2.3	3.7	1.1	3.0	2.3

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

In spite of the decline in its growth rate, the level of real business investment in 1985 remained high owing to its very rapid growth the previous year. Thus, though investment did not contribute strongly to growth in demand, it continued adding to productive capacity. The sharp slowing in its growth in 1985 may have come in response to the smaller slowdown in the growth of overall output. Such an exaggerated investment response is to be expected in the framework of the textbook "accelerator" theory of business investment. The pattern is also typical of postwar recoveries, although it has generally occurred earlier in the expansion than was true last year.

Much of the recent growth in business structures has been concentrated in commercial buildings, such as office buildings, stores, and warehouses. The boom in office building has continued despite extremely high office vacancy rates, but it now appears to be slowing. Tax considerations, particularly proposals to end some of the tax advantages of the real estate industry, may have helped to prolong the boom in office building.

The recent performance of business fixed investment is placed in historical perspective in Figure I-13. Real gross investment as a percent of GNP has recently been at record levels. But net investment--what remains after worn-out and obsolescent capital is replaced--is only at an average level by historical standards. This reflects the fact that the share of GNP spent on equipment, which is relatively short-lived, has been rising over time, while the structures share has remained relatively flat. The figure also shows that the recovery in both gross and net investment from the 1982 recession has been particularly sharp, although much of this expansion in domestic investment has been financed by a lowering of the net U.S. foreign capital position.

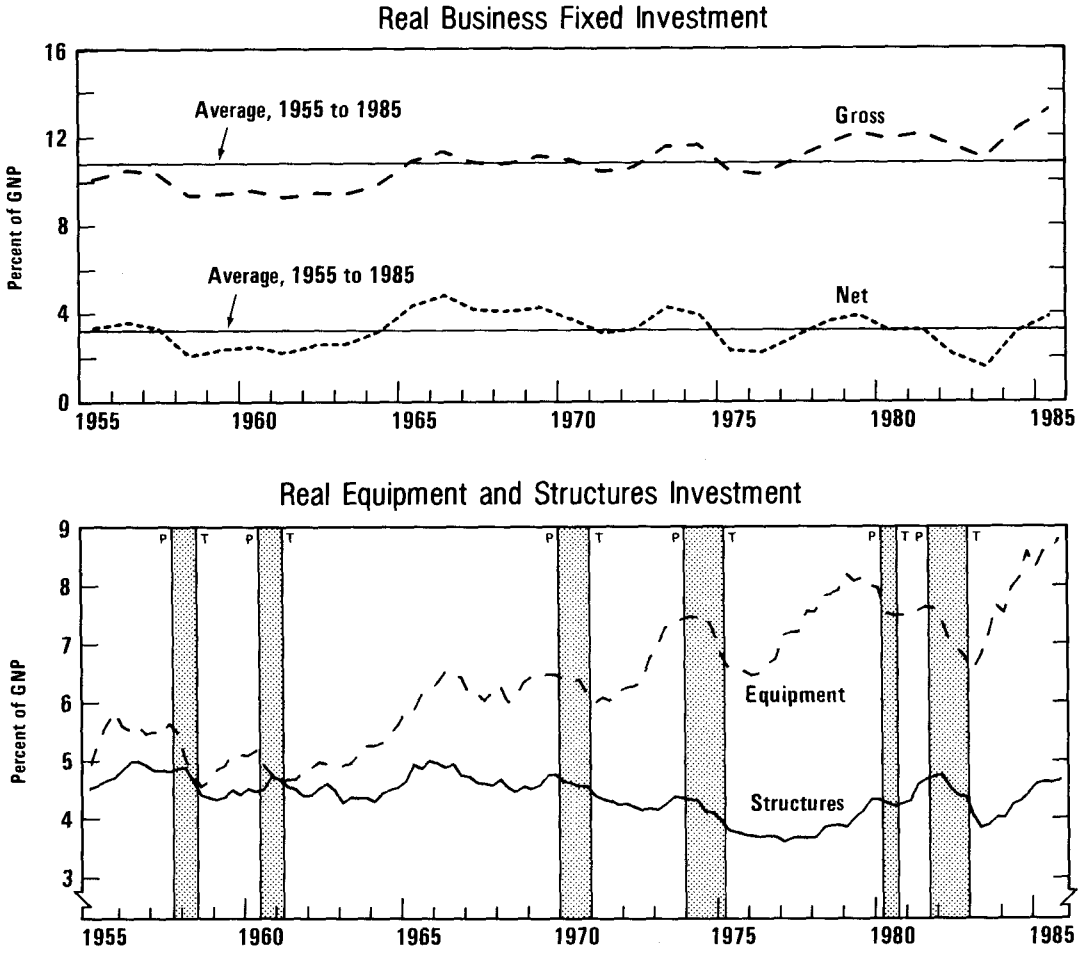
The Outlook for Business Fixed Investment. Current indicators of the outlook for business fixed investment are mixed (see Table I-14). One near-term bellwether, new orders for nondefense capital goods, was up 5.7 percent in the third quarter but rose less sharply in the fourth quarter. December new orders were up sharply (18.6 percent), but the gain was probably temporary, since it reflected bunching in aircraft orders. Capital appropriations of large manufacturing firms fell about 8 percent in the second quarter and another 11 percent in the third quarter. The capacity utilization rate in manufacturing has been essentially flat for the last two years. At roughly 80 percent, capacity utilization has been holding about two percentage points below the average rate for the 1967-1984 period.

By far the most positive signs for business investment are financial data. Corporate profits, adjusted to remove the effects of inventory price

changes and to reflect economic rather than tax-related depreciation, have been quite strong in the current recovery. In the third quarter of 1985, for example, profits were up 14 percent from year-ago levels. The net cash flow of corporations, which includes depreciation and retained earnings, also showed strong growth in 1985. The most dramatic recent development in the financial area, however, has been the decline in interest rates and the rise in the stock market--both of which bode well for business investment. The interest rate on high-quality corporate bonds, a measure of the cost of borrowing to finance investment, declined two full percentage points from the third quarter of 1984 to the third quarter of 1985 and another half point

Figure I-13.

Business Investment



SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: Investment and GNP are in constant 1982 prices. Net investment is gross investment minus economic depreciation. Data for gross and net investment are annual; data for equipment and structures are quarterly.

TABLE I-14. CURRENT INDICATORS OF BUSINESS FIXED INVESTMENT AND SURVEYS OF CAPITAL SPENDING PLANS FOR 1986

	1984	1985	1984 I	1984 II	1984 III	1984 IV	1985 I	1985 II	1985 III	1985 IV
Current Indicators										
Nondefense Capital Goods Orders (billions of dollars per month)	26.9	27.3	26.5	27.5	27.4	26.3	26.8	26.3	27.8	28.1
Manufacturers' Capital Appropriations (billions of dollars, annual rate) a/	116.0	N.A.	115.6	136.4	109.2	116.4	119.6	110.4	98.0	N.A.
Manufacturing Capacity Utilization Rate (percent)	80.8	80.3	79.9	80.7	81.6	81.0	80.5	80.3	80.3	79.9
Corporate Economic Profits (billions of dollars, annual rate) b/	273	N.A.	268	278	271	276	282	288	309	N.A.
Corporate Net Cash Flow (billions of dollars, annual rate) c/	358	N.A.	345	355	363	370	381	390	409	N.A.
Corporate AAA Bond Rate (percent)	12.7	11.4	12.3	13.2	13.0	12.4	12.3	11.6	11.0	10.5
Standard and Poor's 500 Stock Index (annual percent change)	0.0	16.4	-12.4	-11.0	12.9	12.1	32.7	18.0	7.8	19.7

Surveys of Capital Spending Plans for 1986

	Nominal	Real
U.S. Department of Commerce d/	2.4	-1.0
McGraw-Hill Survey e/	-1.0	-5.4

SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis; McGraw-Hill, Inc.; Conference Board; Federal Reserve Board.

NOTE: N.A. = not available.

a. Because of the seasonal adjustment procedure, the annual figure does not equal the average of the quarterly figures.

b. Economic profits are adjusted for inventory valuation and capital consumption allowances.

c. Net cash flow equals corporate retained earnings with inventory valuation adjustment, plus economic depreciation.

d. Conducted in October and November 1985.

e. Conducted in September and October 1985.

in the fourth quarter. Higher stock market prices mean lower costs of investment through equity finance.

On the negative side, uncertainty about tax policy may be holding back investment plans in some sectors. Moreover, surveys of business investment plans for 1986 have been pessimistic. The survey conducted by the Commerce Department in late October and November showed planned investment up 2.4 percent above the 1985 level in nominal terms and down 1.0 percent after adjusting for price changes. The McGraw-Hill survey suggested even lower levels, although it was conducted earlier in the fall and is not adjusted for systematic biases in reporting. It should be noted, however, that neither of these surveys fully reflects the recent decline in interest rates.

Inventories

Business inventory investment showed a substantial decline in 1985 from the record accumulation of the previous year. The pace of inventory accumulation began to slow in late 1984, and inventories actually declined in the third quarter of 1985 for the first time in over two years. The decline was primarily the result of the liquidation of hefty stocks of passenger cars, as well as a decline in farm inventories. Inventories rose again in the fourth quarter as consumption declined and automobile manufacturers restocked their inventories, hoping that a new round of financing incentives would encourage sales in early 1986.

Figure I-14 shows that the real inventory-sales ratio has fallen since late 1983 to levels last seen in the early 1970s. 11/ One plausible explanation of this relatively laggard pace of inventory investment is that the net return to holding inventories has declined. The current expansion has been accompanied by relatively high real interest rates, which raise the opportunity cost of holding inventories. Moreover, in contrast to other postwar recoveries, there has been no acceleration in producer-price inflation, and this weakens the speculative motive to hold inventories. Together, these two factors may have made inventory holding relatively unattractive in the current expansion.

The Outlook for Inventory Investment. Except for autos, inventories now appear generally to be low relative to sales. The rate of inventory investment seems unlikely to decline much farther. The CBO forecast sees

11. Before the recent revision in NIPA data, the real inventory-sales ratio was thought to be near a record low. The revisions raised the real inventory-sales ratio, which is now below the range established since the mid-1970s but within the longer-term historical range.

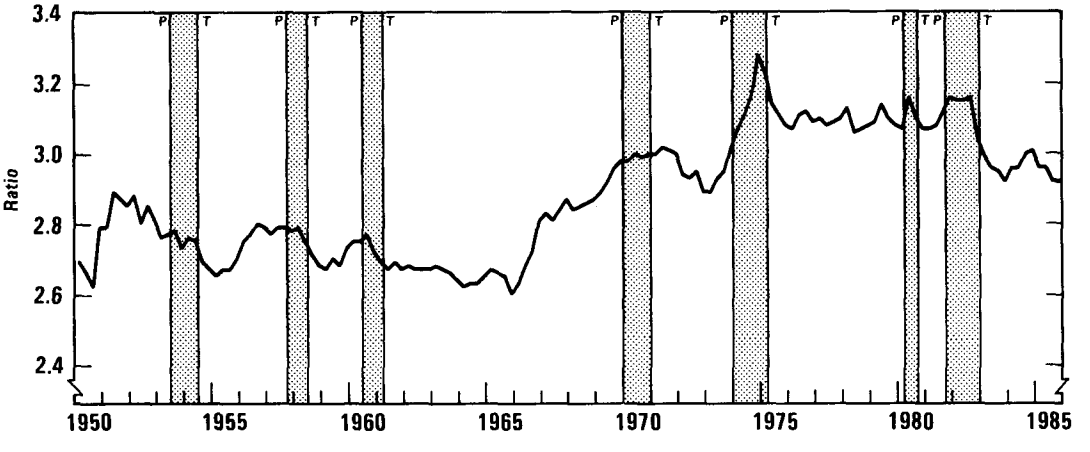
it increasing in the near term and then returning to trend as real interest rates soften and inflation picks up slightly. A stronger increase could occur temporarily, however, if consumption grows less strongly than producers expect.

Residential Construction

Despite the lowest interest rates in years, housing construction remained inexplicably weak over much of 1985. Housing starts, which averaged only about 1.7 million units in 1985, began last year at a relatively healthy pace, slowed during the year, and rebounded at year-end. The slowdown was blamed on a number of factors, such as relatively high inventories of new homes, tightening of secondary market underwriting standards, severe weather, and uncertainty caused by prospective changes in tax laws.

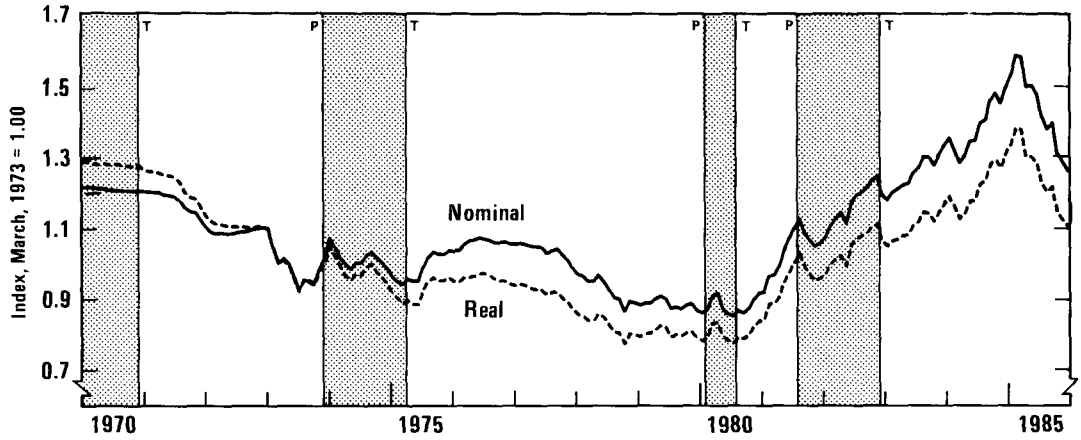
The sharp rise in starts at year-end may signal a recovery in residential construction in 1986. Financial conditions appear to be favorable, and mortgage interest rates may fall somewhat farther in 1986. This drop, combined with the fact that housing price increases are likely to be modest, should make it easier to afford a new house than at any time since the late 1970s. Inventories of single-family homes are now low enough to allow any pickup in new-home purchases to be translated quickly into starts. In addition, the most recent tax proposals have maintained the interest exclusion on second homes and the deductibility of real estate taxes. The final form of this legislation is still unclear, but market

Figure I-14.
Real Inventory-Sales Ratio, Nonfarm Business



SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis.

Figure I-15.
Exchange Rate



SOURCES: Congressional Budget Office; Federal Reserve Board; International Monetary Fund.

NOTE: The nominal index is a trade-weighted average of bilateral dollar exchange rates. The real index adjusts the nominal index for relative movements in CPIs, and is a measure of the relative prices of domestic and foreign goods and services.

expectations have probably become more optimistic. Finally, sufficient mortgage credit should be available to finance a pickup in construction.

Net Exports

The international value of the dollar trended downward over the last three quarters of 1985, falling quite sharply at times, to a monthly average for December nearly 21 percent below that for February (see Figure I-15). Thus, the long upward trend of dollar appreciation that began in the third quarter of 1980 was rolled back approximately to mid-1983 levels.

A number of forces caused this turnaround. Slack in the domestic economy, an accommodating U.S. monetary policy, and an improved likelihood of eventual action on the federal deficit caused real interest rates in the United States to fall relative to those abroad, thereby reducing the attractiveness of dollar assets (see Figure I-16). When the dollar threatened to strengthen again in the late summer, the Group of Five (G5) major industrial nations (France, Japan, the United Kingdom, the United States, and West Germany) responded by calling for further orderly depreciation of the dollar, and pledged cooperation to encourage this outcome. In effect, the United States substantially revised its stance against official intervention in currency exchange markets. 12/

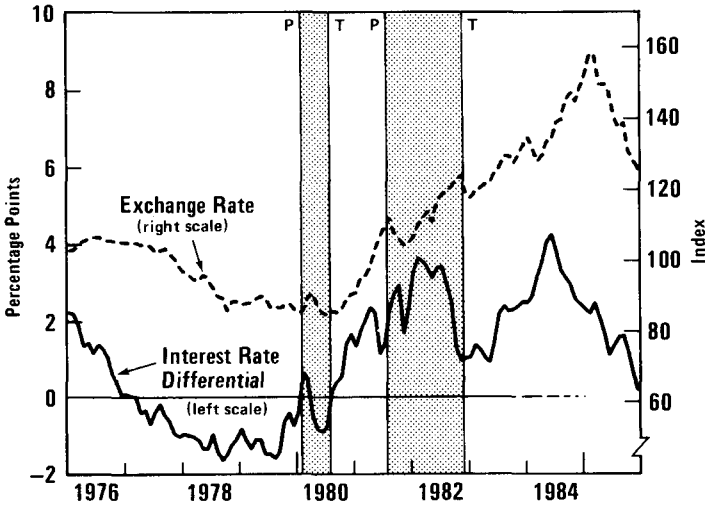
12. Intervention is the buying or selling of currencies by official monetary authorities.

Because trade responds to exchange-rate movements with a considerable lag, the decline in the dollar exchange rate last year has so far had little observable effect on U.S. international trade. Net exports continued to fall last year, but revisions in the trade data make it especially difficult to assess the present situation. One reason for the unusually large recent revisions of the trade data is to correct for reporting delays that distort the measurement of actual trade flows and thereby also of GNP growth rates (see Box I-4).

The Trade Deficit and the Standard of Living. One consequence of the large current-account deficits in recent years is that foreigners have been acquiring more and more assets in the United States, such as business capital, real estate, and government bonds, as a result of this country's need to sell dollar-denominated assets to other countries in order to finance the balance-of-trade deficit.

That foreigners own more and more productive capital in this country is reflected in the difference between the growth rates of gross national product (GNP) and gross domestic product (GDP). Broadly speaking, GDP represents the output produced by labor and capital located in the United States, regardless of who owns it. GDP differs from the more familiar GNP measure, which represents, broadly, the flow of production from labor and capital owned by U.S. residents regardless of where it is located in the

Figure I-16.
The Exchange Rate and Relative Interest Rates



SOURCES: Congressional Budget Office; Federal Reserve Board; International Monetary Fund.

NOTE: The exchange rate is a trade-weighted average of bilateral dollar exchange rates. The real interest-rate differential is the difference between long-term real interest rates for the United States and a GDP-weighted average for other industrial countries. Long-term real interest rates are long-term nominal interest rates (on government bonds), adjusted for expected inflation rates. Expected inflation is proxied by a two-year centered moving average of actual and projected CPI inflation rates.

BOX I-4

MERCHANDISE TRADE DATA REPORTING PROBLEMS

Recently the Bureau of the Census revealed that as much as one-half of the value of imports normally reported during what is termed a statistical month actually entered the economy in previous months. Such delays occur because of lags between the actual passage of imported goods through Customs and the receipt by the Census Bureau of the underlying documents. This problem has serious implications for the National Income and Product Accounts (NIPA). The NIPA data are based in part on Census Bureau trade flow reports, and are meant to register current economic developments, rather than the receipt of the corresponding documentation.

Discrepancies between statistical and actual-month import values since the beginning of 1984 ranged from less than $0.1 billion to $4.2 billion, averaging $1.8 billion per month or about 6 percent of average monthly import values. At least nine times over the last two years, statistical data misstated the direction of change of actual imports in a given month. The Census Bureau advises that at least four months of data are needed before actual monthly import values can be estimated accurately.

Recent broad revisions of the NIPA by the Department of Commerce's Bureau of Economic Analysis (BEA) include all available information on actual trade flows. For contemporaneous-quarter GNP calculations, BEA now relies primarily on its own estimates of trade flows rather than on reported statistical-month data. Although this procedure improves the ultimate accuracy of the NIPA data, it also increases the likelihood that significant revisions will have to be made as the actual trade data become available.

world. Net inflows of foreign capital reduce GNP relative to GDP because the income earned by foreign-owned capital in this country is reflected in GDP but not in GNP (see Box I-5).

In the past four years, the growth rate of real GDP exceeded that of real GNP by an average of 0.2 percentage points (see Table I-15). The difference can be viewed as the price that the United States is beginning to pay, in terms of reduced income, for having borrowed so much abroad.